

AN INTEGRATED POVERTY ALLEVIATION MODEL COMBINING ZAKAT, AWQAF AND MICRO-FINANCE

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ABSTRACT

In this paper, we present a model that integrates two traditional Islamic tools for poverty alleviation: Zakat and Awqaf, with the evolving concepts of Islamic micro-finance. We also analyze the often-made criticisms of conventional micro-finance and attempt to develop the concept of an Islamic micro-financing institution that may overcome such short-comings. We elaborate on the overall framework of the proposed model, its sources of funds, investment modes and its management aspects.

Key Words: *zakat, awqaf, microfinance, Islamic, poverty alleviation*

JEL Classification: G21, G24, L26, P51

1. POVERTY: CONCEPTS AND VIEWS

Poverty is a multidimensional economic phenomenon that has both political and social ramifications. It exists throughout generations and societies irrespective of cultural affiliation and geographical boundaries. Although the nature of poverty may vary from community to community, culture to culture and time to time, poverty persists in both rural and urban areas alike; and also in both developed and developing economies.¹

1.1 Definition of Poverty

Schubert (1994) identifies and establishes different poverty features. Poverty is less extensive in urban than in rural areas, as chances of employment and income growth in urban areas are higher. As agricultural activities are associated with the uncertainty of natural disasters and cyclical properties of crop cycles and climatic cycle, the rural poor dependent upon agriculture suffer from poverty of a seasonal nature.

The urban poor generally engage in low-skilled and low-paying jobs such as day laborer, mason, and cleaner, etc. There is a cause-and-effect relationship between family size and poverty. Larger families are more likely to suffer from severe poverty than smaller ones. Lack of education and poverty also has a cause-and-effect relationship as lack of education leads to a low level of human capital and capacity. In general, poverty density is relatively higher in localities that lack infrastructure and facilities.²

1.2 Different Approaches to Anti-Poverty Programs

Anti-poverty programs can be broadly classified into two strategies: (a) Indirect Strategies: that formulate a macro-economic policy framework to ensure sustainable growth, higher employment, higher per capita income, and eventually reduce poverty; and (b) Direct Strategies: that target the underprivileged population and provide them

¹ Alhabshi, Datuk Dr. Syed Othman, "Poverty Eradication From Islamic Perspectives", p. 01.

² Hassan, M. K. and Md. Juanyed Masrur Khan, (2006), "Zakat as a tool for poverty alleviation in Bangladesh", pp. 07-08.

necessary assistance to ensure credit access, improve health conditions, increase literacy rate and ultimately eradicate poverty (Pramanik, 1994).³

Indonesia, Malaysia, and Thailand are good examples of countries that have alleviated poverty through indirect strategies. These countries pursued consistent macroeconomic policies that ensured growth of six percent or greater and increased public spending on education, health, family planning, etc. for decades. In contrast, Bangladesh is an example of direct policy application where government and non-governmental organizations provide a set of services for the targeted poor population like ensuring access to credit, health care and educational services to targeted underprivileged individuals (CPD, 1996).

2. ISLAM AND POVERTY ERADICATION

Islamic principles of poverty alleviation are based on the Islamic views of social justice and the belief in Allah Almighty. Islam defines poverty as a state whereby an individual fails to fulfill any of the five basic human requirements of life: (a) Religion, (b) Physical self, (c) Intellect or Knowledge, (d) Offspring, and (e) Wealth.

The Islamic economy identifies individual differences among people as each person is endowed with different types and levels of human abilities. Thus, even though individuals are provided with equal opportunities, the economic status of two individuals may not be equal.⁴ Therefore, poverty cannot be alleviated simply through income redistribution or ensuring equitable opportunities for all. An Islamic approach to poverty alleviation would ideally involve a holistic approach including a set of anti-poverty measures: (a) increasing income level with pro-poor programs, (b) achieving an equitable distribution of income and (c) providing equal opportunities for all social segments.⁵

2.1 Poverty Eradication Strategies in Islam

The Islamic approach involves three distinct sets of measures: (1) positive measures, (2) preventive measures, and (3) corrective measures, as presented in the Figure 1:

2.1.1 Positive Measures: Islam engages different positive measures in alleviating poverty: (a) income growth, (b) functional distribution of income, and (c) equal opportunity.⁶

a. Income Growth: Islam emphasizes moderate consumption behavior at individual level that produces necessary savings for both the individual and the overall economy and also stresses on the need for halal earning. The Quran teaches us that: (1) “A person gets what he or she strives for.” (53:39), (2) “Earning a halal living is farz (obligatory) after obligatory rituals.” (Al Baihaqui, Tabarani), and (3) “Do not make your hand tied to your neck, nor stretch it forth to its utmost reach, so that you become blameworthy and destitute.” (17:29) (Sadeq, 1995)

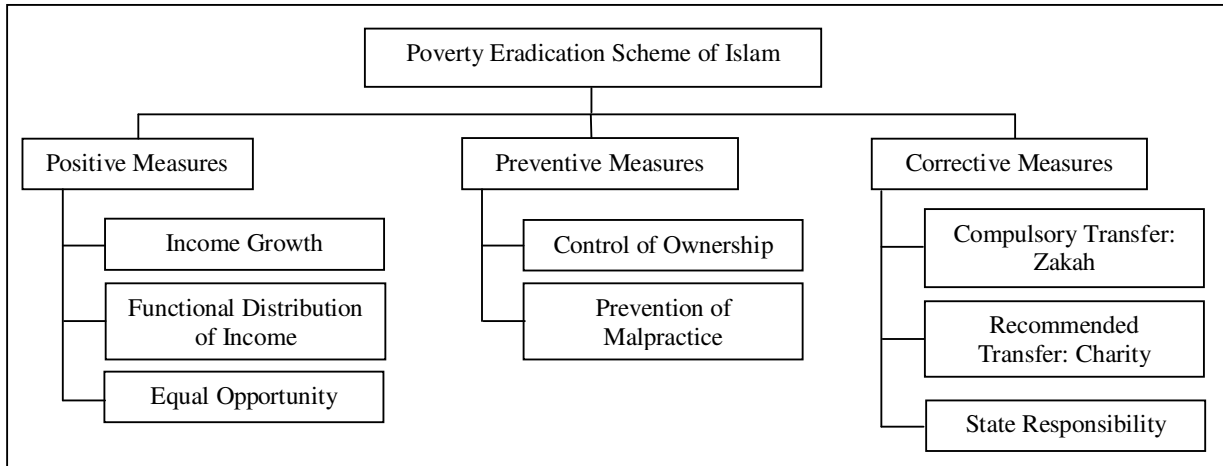
³ Hassan, M. K. (2006), “The Role of Zakat in Poverty Alleviation in Bangladesh”, pp. 06-07.

⁴ Alhabshi, Datuk Dr. Syed Othman, “Poverty Eradication From Islamic Perspectives”, pp. 03-04.

⁵ Hassan, M. K. (2006), “The Role of Zakat in Poverty Alleviation in Bangladesh”, p. 13.

⁶ Hassan, M. K. (2006), “The Role of Zakat in Poverty Alleviation in Bangladesh”, p. 13.

Figure 1: Poverty Eradication Scheme of Islam



Source: A. M. Sadeq, 1995, Poverty Alleviation: An Islamic Perspective.

b. Functional Distribution of Income: Functional distribution of income refers to equitable distribution of income among all the factors of production in absence of which high income-growth alone may not be able to alleviate. Islamic norms ensure that the principle for factor pricing is based on justice and fairness. The Quran teaches us that: (a) “Allah commands justice and benevolence.” (16:90), and (b) “Woe to those that deal in fraud; those when they receive from man take full measure, but when they give by measure or weight to others give less than due.” (83:1-3).

Islamic approach recommends measures for an equitable distribution of income among factors of production such as profit sharing. Islam prohibits Riba and emphasizes the distribution of profits on the basic definition of ratio, rather than a nominal fixed interest among the stakeholders (Sadeq, 1995).

2.1.2 Preventive Measures: Islamic economy also ensures preventive measures be taken so that wealth is not concentrated in a specific section of a population; such as: (a) control over ownership, and (b) prevention of malpractices.⁷

a. Control of Ownership: In Islam, ownership of everything belongs to Allah Almighty. Man has the secondary ownership, as trustee, for utilizing resources per the terms and conditions of the trust. In an Islamic economy, resources identified for public use, such as natural resources, cannot be privately owned. The state should own such resources so that they are accessible to all sections of the population when necessary. However, Islam allows private ownership in business and industry as long as they are performed based on Islamic ethics and norms.

b. Prevention of Malpractice: Islam identifies and prohibits malpractices that lead to economic disparity such as gambling, hoarding, cheating, bribery, and interest or Riba. The Quran teaches us: “O ye believe! Squander not your wealth among

⁷ Hassan, M. K. (2006), “The Role of Zakat in Poverty Alleviation in Bangladesh”, p. 13.

yourselves wrongfully, except it be a trade by mutual consent.” (4:29) In modern times, such malpractices take different forms. If all such malpractices including corporate frauds and other white-collar crimes are prevented, inequality in income distribution could be avoided (Sadeq, 1995).

2.1.3 Corrective Measures of Poverty Eradication: The third set of anti-poverty measures: the “corrective measures” fosters wealth transfers so that wealth is not concentrated among the wealthy through; (a) compulsory transfers (Sikh), (b) recommended transfers (charity), (c) state responsibility (enforcement and basic needs).

a. Compulsory Transfer (Zakat): Islam establishes Zakat as a compulsory for all well off Muslims. Zakat is a unique instrument for poverty alleviation as wealth is transferred from well-off people to worse-off people. Islam identifies Zakat as one of the five pillars. Anybody denying obligation of Zakat ceases to be a Muslim. According to the Quran: “The Zakat is meant only for the poor and needy, those who collect the tax, those whose hearts are to be won over, for the freeing of human beings from bondage, for the relief of those overwhelmed by debts, for the cause of God, and for the wayfarer: [this is] an ordinance from God- and God is All-Knowing, Wise”. (9:60).

b. Recommended Transfers (Charity): Islam encourages charity and acts of benevolence rather than mandatory transfers like Zakat and Sadaqat al-Fitr. The Quran teaches us: (1) “And in your wealth, are obligations beyond Zakat.” (2) “In their wealth, there is a known right for those who ask for it and for the deprived.” (70:24-25). Thus, charity and other acts of benevolence are highly recommended. In the case of strong economic disparity or poverty, such transfers would become obligatory (Sadeq, 1995).

c. State Responsibility: In the Islamic system, the state should be held responsible for maintaining a favorable environment for legal business and economic activities. The state should also protect its citizens from malpractice of any form. Finally, the state should enhance the institution of Zakat and provide equal opportunities for all.⁸

2.2 Comparison of Islamic Tools for Poverty Alleviation

In Islam, two charities, compulsory (such as Zakat) and optional (Sadaqa) engage in initiatives of poverty alleviation through the redistributive approach. On the other hand, the third type of charity, Perpetual (Awqaf), is used to improve non-income aspects of the poor such as health and education as well as increasing their access to physical facilities, resources, and employment.⁹ Need to say explicitly what physical facilities and resources are available or give an example in parentheses. Table 01 summarizes the key features of three basic tools for poverty alleviation and briefly compares them.

⁸ Hassan, M. K. (2006), “The Role of Zakat in Poverty Alleviation in Bangladesh”, p. 14.

⁹ AbdulHasan M. Sadeq (1995), “Awqaf, perpetual charity and poverty alleviation”, p. 137.

Table 1: Comparison of Poverty Eradication Tools in Islam

	Zakat	Lillah	Awqaf
Compulsory/ Voluntary	Compulsory	Voluntary	Voluntary
Rate	Fixed rate	Any amount	Any amount
Expense categories	8 Fixed expense categories	Flexible expense categories. Donor can decide.	Flexible expense categories. Donor can decide
Spend	Generally spent in one year	Generally spent in one year	Generally Capitalized
Investments	Generally not invested – needs to be discharged as soon as possible	Generally not invested – may be discharged according to need and mandate	Invested in social or economic asset
Shariah governance: Liability	Liability for payment is governed by Shariah	Any person can give	Donor must be sane, of age, male or female
Mutawallee	Mutawallee not necessary	Mutawallee not necessary	Must appoint Mutawallee (trustee)
Document	No document necessary	No document necessary	May be done through a Awqafiyah (Donation Deed)
Sadaqah Jariyyah	Generally not continuous	Generally not continuous	Always a continuous charity and continuous reward
Capital base	Not a capital base	Not a capital base	Forms a Capital Base for Sustainable Community Development
Beneficiaries	Applied only to Muslims	May be applied to all irrespective of creed.	May be applied to all irrespective of creed.
Time for payment	Generally paid in Ramadaan	Can be paid at any time	Can be paid at any time
How payment is effected	Generally paid in cash or stocks	Can take the form of any asset	Can take the form of any asset – cash, land, coins, jewellery

Source: National Awqaf Foundation of South Africa-Questions and Answer, 2007.

2.3 Zakat as a Tool for Poverty Alleviation

Islam establishes zakat as a compulsory charity tool that can be used on eight purposes. Among them, five are meant for poverty eradication such as the poor, the needy, the debtors, the slaves (to free them from captivity), and the travelers in need. Other heads are the administrative cost of Zakat, 'those whose hearts are made inclined' (to Islam), and in the way of Allah. Although eight heads for spending Zakat revenue have been mentioned in the Qur'an, there is general agreement that the first priority in the use of Zakat funds has to be accorded to the alleviation of poverty through assistance to the poor and the needy.¹⁰

2.3.1 The Nisab of Zakat: There are several opinions regarding which articles would be considered for Zakat. One opinion considers that Zakat is only imposed on four types of agricultural products (wheat, barley, dates and resin), gold and silver, and freely pastured camels, cows, and sheep. However, such items would only constitute a part of the wealth of rich people of modern societies, as wealth and income have taken other forms. Another view of Nisab considers that Zakat must be imposed on the wealth and income of the rich that exceeds the normal and customary personal and

¹⁰ Hassan, M. K. (2006), "The Role of Zakat in Poverty Alleviation in Bangladesh", p.16

family expenditures, like: business assets, bank accounts, financial assets and rentable buildings (Hassan and Khan, 2007).¹¹

2.3.2 Scope of Zakat: Zakat can be used as part of a long-term strategy for poverty alleviation. The views expressed by the founder of three scholars of jurisprudence, namely, Shafi, Malik, and Ahmed bin Hanbal are noteworthy. “According to Malik and Ahmed bin Hanbal, the amount paid in Zakat must be enough for one year's requirement. Imam Shafi treats this in a life term perspective and maintains that the poor should be given Zakat enough for their lifelong requirements of a normal life span.”¹² A Fatwa issued by the International Shari’ah Board on Zakat (ISBOZ) explains that Zakat funds might be used in undertaking development projects, educational services, and health care services as long as the beneficiaries of such projects fulfill the criteria to be recipients of Zakat.¹³

2.3.3 Zakat As An Alternative Source Of Funding: Zakat funds, if collected and managed properly, could be used to create a *pull of funds* which can be used in financing development activities and can replace government expenditures. In Bangladesh, Zakat funds could have contributed up to 21% of the Annual Development Plan (ADP) in 1983/1984 and up to 43% of ADP in 2004/2005; this amounts to TK.30,683 million in 1983/1984 and TK. 220,000 million in 2004/2005.¹⁴ In developing countries such as Bangladesh, foreign aid from donors contributes a significant portion of the development budget. If Zakat funds are properly managed, these funds could replace foreign aid and therefore significantly reduce the debt burden. (Hassan and Khan, 2007)

2.4 Awqaf

In the Arabic language, the word Awqaf literally means hold, confinement or prohibition. In the Islamic system, Awqaf is a perpetual charity that means holding certain property and preserving it for the confined benefit of certain philanthropic purposes. Although Awqaf applies to non-perishable properties like: fixed property, land or buildings, it can be applied to cash money, books, shares, stocks, and other assets. The concept of Awqaf is a well-practiced phenomenon in recent times in both the Muslim and non-Muslim world. In North America, such Awqaf institutions are rendering a wide range of services by providing religious education, community services and maintenance of the Mosques (Kahf).¹⁵

2.4.1 Kinds of Awqaf: Awqaf can be classified into different kinds based on its purpose or uses. The following are the most common Awqaf:

- a. **Religious Awqaf** focuses on maintenance of Religious institutions, like: mosques and madrasas and their adjacent premises and properties.
- b. **Philanthropic Awqaf** aims at providing support for the poor, such as: health services, as well as education. In the early days of Islam, Prophet Muhammad (S.A.W.) initiated this type of Awqaf with the objective to reduce the disparity and inequality among the social strata.

¹¹ Hassan, M. K. and Md. Juanyed Masrur Khan (2006), “Zakat as a tool for poverty alleviation in Bangladesh”, pp. 10-11.

¹² Hassan, M. K. (2006), “The Role of Zakat in Poverty Alleviation in Bangladesh”, p. 16.

¹³ Kahf, Monzer (2006), “Role of Zakat and Awqaf in Reducing Poverty: A Case for Zakat-Awqaf-Based Institutional Setting of Micro-finance”, p.10.

¹⁴ Hassan, M. K. and Md. Juanyed Masrur Khan (2007), “Zakat as a tool for poverty alleviation in Bangladesh”, p. 18.

¹⁵ Kahf, Awqaf And Its Sociopolitical Aspects”, p. 04.

- c. **Family Awqaf** is a unique kind of Awqaf that ensures Awqaf proceeds are given to the family and descendents in the first place and then the excess be given to the poor. This is in contrast to traditional trusts in western society that allows for no benefits towards the families and only to religious or philanthropic purposes (Kahf).

2.4.2 Legal Conditions Of Awqaf: The creation of a Awqaf involves some legal obligations such as: (a) The property must be a real asset that has some meaning of perpetuity such as land, buildings, camels, cows, sheep, books, jewelry etc. (b)The property should be given on a permanent basis. (c)The Awqaf founder should be legally fit and apt to take such an action and a child, an insane person, or a person who does not own the property cannot make Awqaf. (d)The purpose of the Awqaf must be an act of charity from both points of view of Shariah and of the founder. (e) Finally, beneficiaries, person(s) or purpose(s), must be alive and legitimate.

However, Awqaf can be in cash as well. In the first century of Hijrah, a cash Awqaf was in practice in two forms: (1) cash for free lending to the beneficiaries, and (2) cash for investment and its net return as assigned to the beneficiaries.¹⁶ Such cash Awqaf became very common in the later stage of the Ottoman Empire as well.

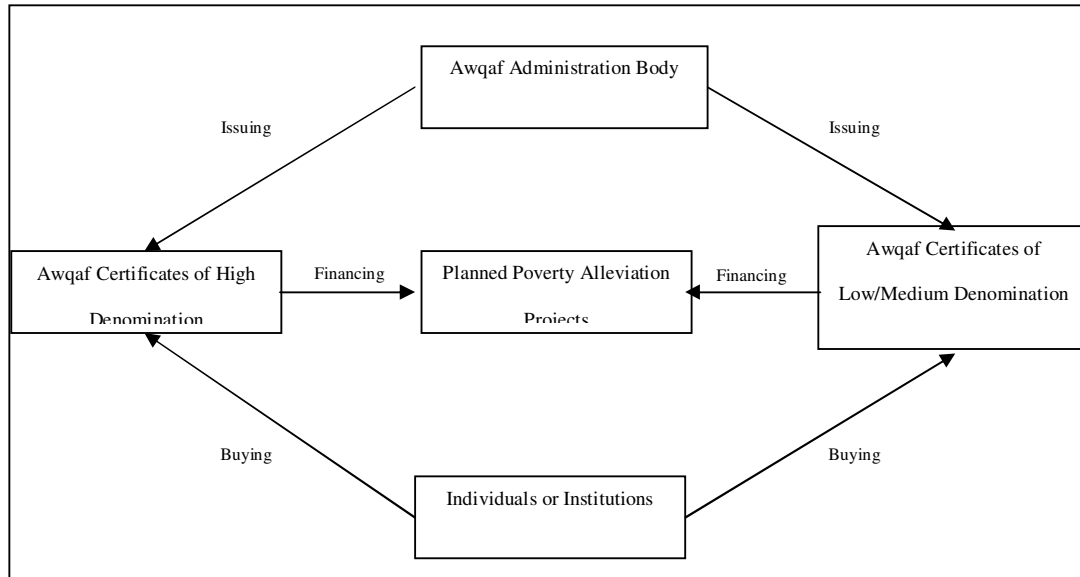
2.4.3 Scope of Awqaf as tool for Poverty Alleviation: As the primary focus of Awqaf is philanthropy, on principle, its objectives are in line with poverty alleviation objectives. In modern times, Awqaf can be rejuvenated through innovative approaches and at the same time comply with Islamic principles. AbdulHasan M. Sadeq (1995) presents an integrated approach on how traditional institutions of Awqafs may be revitalized through innovations.¹⁷ Awqaf certificates of different denominations could be issued to raise the cash Awqaf, so that a number of individuals or institutions may buy them and finance the development projects. Besides, cash Awqafs could be encouraged among people through building confidence on management.

Awqaf funds raised from issuing certificates and cash Awqafs can be used in creating a pool of funds (similar to the pool of Zakat funds mentioned before) for financing development projects. As Awqafs are generally applied on fixed assets, such assets are often under-utilized. On the other hand, if cash Awqafs are raised by issuing Awqaf certificates, they could be used more efficiently in a wide range of development projects.

¹⁶ Kahf, Monzer (2006), "Role of Zakat and Awqaf in Reducing Poverty: a Case for Zakat-Awqaf-Based Institutional Setting of Micro-finance", p.10.

¹⁷ AbdulHasan M. Sadeq (1995), "Awqaf, perpetual charity and poverty alleviation", p. 143.

Figure 2: Issuing of Awqaf Certificates to Finance Development Project



Source: AbdulHasan M. Sadeq

2.5. Weakness of Traditional Zakat Management

Although in early Islamic states, Zakat funds were collected and managed by the state, Zakat management has gone through historical challenges after the extinction of early Islamic states. After the colonial era, a few Muslim countries such as Yemen, Saudi Arabia, Libya, Sudan, Pakistan, and Malaysia have opted for mandatory Zakat management through government. Other countries such as Egypt, Jordan, Kuwait, Iran, Bangladesh, Bahrain and Iraq, have formed specialized state institutions but participation of public is made voluntary.

However, in most Muslim countries, the contribution of Zakat from Zakat donors to such managed Zakat funds has been less significant because of different reasons: a) Individual Zakat donors usually have preferences over whom they should pay Zakat - in some cases their close relatives and neighbors; b) The low credibility of management because of government involvement; c) More importantly, in National Zakat Management Fund, which has little knowledge regarding the eligibility of recipients.

2.6 Weakness of Traditional Awqaf Management

From the legal point of view, the ownership of Awqaf property lies outside the person who created the Awqaf. The Awqaf manager, also known as Mutawalli, is held responsible for the overall management of the Awqaf property to ensure the best interest of the beneficiaries. Usually the Awqaf documentations mention how the Mutawalli be compensated for this effort. If the document does not mention such compensation for the Mutawalli, the Mutawalli either volunteers the work or seeks assignment of compensation from the court.¹⁸

¹⁸ Kahf, Awqaf And Its Sociopolitical Aspects", p. 04.

Historically, Awqaf played an important role in the socio-economic development in Islamic societies during the early days of the Islamic era. In early nineteenth century, a special ministry was established for Awqaf in the Ottoman Empire and different laws of Awqaf were enacted. Among them, the most important was the Law of Awqaf of Nov. 29, 1863 (19/6/1280 of the hijrah calendar) that remained in effect in several countries (Turkey, Syria, Iraq, Lebanon, Palestine, Saudi Arabia) for many years after the break-up of the Ottoman Empire in 1918.

Over many centuries, the institution of Awqaf has been systematically destroyed by both the colonial rule, and later on, by post-colonial nationalization of Awqaf management. One reason behind the vengeance against the Awqaf institution was that religious education enjoyed major contributions, which was a cause of rebellion during colonial and post-colonial eras. This systematic destruction of Awqaf management has led to its present problems, like: a) Low credibility of management because of government involvement, b) Lack of research about the modernization of Awqaf as an Islamic institution, c) Lack of consensus among different schools of thought of Islam about Awqaf laws and their implications.

3. CONVENTIONAL MICRO-FINANCE AND ISLAMIC MICRO-FINANCE

3.1 CONVENTIONAL MICRO-FINANCE

Over the last three decades, micro-finance has evolved as a major financial innovation in providing collateral free credit access to the poor. Microfinance assumes that, to the micro-entrepreneurs, lack of collateral is the most important obstacle in availing formal credit and it hinders the overall investment and profitability of the business. So micro-finance aims at providing collateral free financial services to the poor to assist them develop micro-businesses, increase their income level and eventually get out of the poverty trap (Dichter, 2007).¹⁹

However, the definition of micro-business in micro-finance is not well-defined and it may vary from country to country depending on the country's stage of development, policy objectives, administration, etc. (World Bank 1978). Micro-businesses and medium enterprises are generally identified by amount of fixed capital and the number of workers and usually they involve economic activities in three broad categories: production, trading, and providing transport services²⁰.

3.1.1 Weaknesses of Conventional Micro-finance

Although the key objective of micro-finance is providing credit access to the poor, there has been much debate among development specialists regarding what activities actually constitute a micro-business and whether or not micro-finance is being used merely for consumption smoothing purpose only. Micro-financiers have been promoting non-firm activities among the rural poor to encounter against the inherent seasonal trend of agro-economic activity that generates irregular cash flows. However, in many cases the borrowers start up taking loans for micro-business but end up with fulfilling immediate consumption needs turning micro-finance into a merely consumption-smoothing act.

¹⁹ Dichter, Thomas (2007), "A second look at Micro-finance: The sequence of Growth and credit in economic history", p. 01.

²⁰ Ahmed, Habib (2002), "Financing Microenterprises: An Analytical Study Of Islamic Micro-finance Institutions, p. 03.

Another problem with micro-credit is the basic assumption that the poor can be good entrepreneurs given access to credit. However, in developed countries people usually prefer jobs to entrepreneurship as they are more risky. There is no reason to assume that the poor would possess better entrepreneurial skills following their basic economic activities that serve subsistence purposes only such as going to a nearby commodity market to buy and sell basic consumption and agricultural products (Dichter, 2007).²¹ Apart from these crucial debates, there are some other impediments that endanger the desired effects of micro-finance on poverty alleviation. We explain such problems as follows (Ahmed, 2002).

- a) **Asymmetric Information Problems:** Although conventional micro-financing institutions focus on participation of women in entrepreneurial development, eventually such loans may end up in the hands of male members and being used for other purposes, as the society itself is male dominated (Rahman 1999). Such diversion of credit can easily lead to higher loan defaults and lead to adverse selection problem for the micro-financing institutions.²²
- b) **Economic Viability of MFIs:** One of the major financial challenges of the traditional micro-credit institutions (hereafter mentioned as MFI's) is their high operating and administrative cost for monitoring loan operations closely as they engage in small collateral free credits to a large number of borrowers. Bennett (1998) reports that the administrative cost of five MFIs in South Asia is in the range of 24% to 400% for per dollar lent. Besides this, another concern for conventional MFIs is their dependency on foreign aid as ensuring constant and predictable foreign aid may become increasingly difficult in future in the changing business environment.
- c) **Charging Fixed Interest Rates:** Usually, MFIs pursue a standard and generalized policy of lending rates in different loan categories. However, profitability of a similar project may be different because of differences in geographic or demographic conditions. For example: a project located in community better equipped with infrastructure may become more profitable than a similar project in a community that lacks good infrastructure. In such cases, charging a fixed specific interest rate irrespective of project features may be counter-productive from a poverty alleviation objective.
- d) **Higher Interest Rates and focus on short term loans:** One of the reasons behind the most common allegation against conventional MFIs of higher interest rate is the imbalance in their investment portfolio and capital structure. Although the major portion of the capital and liability structure is long term, their investments are generally short term focused that creates additional pressure on liquidity. As a result, MFI's charge higher interest on their clients to ensure short-term investable funds and to cover up the high administrative costs.²³

²¹ Dichter, Thomas (2007), "A second look at Micro-finance: The sequence of Growth and credit in economic history", p. 01.

²² Ahmed, Habib (2002), "Financing Microenterprises: An Analytical Study Of Islamic Micro-finance Institutions, p. 07.

²³ "ISLAM, LAND & PROPERTY RESEARCH SERIES"; Paper 8: Islamic Credit And micro-finance UN-HABITAT 2005, p. 12.

- e) **Low Rate of Return on Investment:** Conventional MFIs engage in financing micro-business activities that usually substitute the agricultural or farm activities and require fewer skills. Often, such micro-business activities are related to the production of basic commodities, transportation, and trading at smaller scale ventures. However, as more and more households become involved in such ventures, return on such loans decreases as the supply side of such activities increases (Osmani, 1989).

- f) **High Dropout Rate and Non-Graduation from Poverty:** The objective of micro-finance is to enhance micro-businesses and eventually alleviate poverty through ensuring a sustainable growth in their income level. Unfortunately, as micro-businesses often involve very basic activities that possess low returns, the borrowers fail to attain desired income growth and fail to upgrade from poverty. Such non-graduation from poverty and other factors such as access to other competing MFIs for credits could lead to higher dropout rates. Karim and Osada (1998) report that there is a steady increase in the dropout rate from Grameen Bank (15% in 1994).²⁴

- g) **Debt Trap:** Increased dropout and non-graduation from poverty among the borrowers may result in a vicious cycle of poverty. As conventional MFIs engage in strict recovery measures such as peer group pressures and social segregation, unsuccessful borrowers are to some extent forced to repay loans at any costs. Rahman (1996) discovered that the Grameen Bank borrowers often take loans from other sources to pay installments and are trapped in a spiraling debt cycle.²⁵

- h) **Non-Conforming to Popular Religious Beliefs:** A major challenge that conventional MFIs while operating in Muslim communities is the non-conformance of the credit system to the popular religious beliefs. As usury (Riba) is prohibited in Islam, the clergy in the rural areas and conservative Muslim societies exhibit resistance to conventional micro-financing. Another issue is the focus of credit to women. In some cases, this focus has created social conflict in conservative populations. In extreme cases, although women are the recipients of credit, the credit ends up with the male member of the family, leading to misappropriations and credit diversion.

- i) **Credit Rationing:** Imperfect information on behalf of the loan officers and higher interest rates may lead to the problem of credit rationing where only projects with higher profit probability may be selected. That way the true spirit of poverty alleviation through micro-credit may be hampered and overall economic welfare may be endangered. (Dhumale).²⁶

3.2.0 ISLAMIC MICRO-FINANCE

Over the past three decades, Islamic banking has grown significantly at annual rate of over 15% with an overall capitalization of US\$1.3 trillion at present. (UN-HABITAT, 2005).²⁷ Compared to Islamic banking, Islamic micro-credit is an evolving concept

²⁴ Ahmed, Habib (2002), "Financing Microenterprises: An Analytical Study Of Islamic Micro-finance Institutions", p. 08.

²⁵ Ahmed, Habib (2002), "Financing Microenterprises: An Analytical Study Of Islamic Micro-finance Institutions", p. 08.

²⁶ Dhumale, Rahul and Amela Sapcanin (2002), "An Application of Islamic Banking Principles to Micro-finance", p. 05.

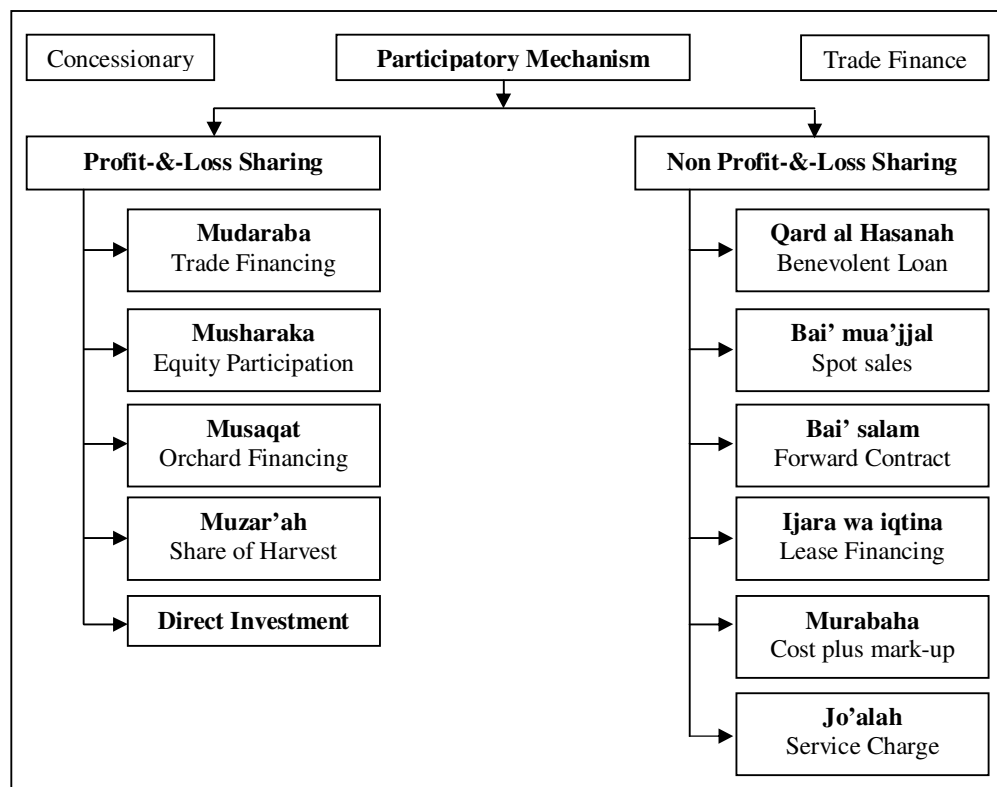
²⁷ "ISLAM, LAND & PROPERTY RESEARCH SERIES"; Paper 8: Islamic Credit and Micro-finance UN-HABITAT 2005, p. 05.

with an outreach in mostly the Arab world and has grown considerably to more than 700,000 borrowers in 2003.²⁸ As an effective alternative to conventional micro-financing, Islamic micro-financing institutions (mentioned hereafter: IMFIs) are evolving in different countries as well. Ahmed (2002) points out some elementary comparisons between IMFIs and conventional MFIs discussed below.²⁹

3.2.1 Sources of Funds: Apart from the basic difference in principle of profit based systems and interest-based systems, IMFIs differ from conventional MFIs in their liability and capital structure. Unlike conventional MFIs that depend on interest free or low interest foreign aid, IMFIs may collect funds from religious contributions through the institutions of Awqaf, Zakat, and other charities.

3.2.2 Modes of Financing: While the conventional MFI's asset portfolio is of fixed interest nature, IMFI's asset portfolios should feature diversity in terms of mode of financing and areas of financing. Figure 03 describes the basic categories of diversified financial products the Islamic financing system offers:

Figure 3: Financing Modes in Islamic System



Source: Kazarian 1993; Iqbal and Mirakhor 1987³⁰

Apart from interest-free loans (Qard-Hasan), the principles of Islamic financing can be broadly classified as partnerships (Shirakat) and exchange contracts (Mu'awadat).

²⁸ Dhumale, Rahul and Amela Sapcanin(2002), "An Application of Islamic Banking Principles to Micro-finance", p. 04.

²⁹ Ahmed, Habib (2006), "Financing Microenterprises: An Analytical Study Of Islamic Micro-finance Institutions", pp. 09-15.

³⁰ Dhumale, Rahul and Amela Sapcanin (2002), "An Application of Islamic Banking Principles to Micro-finance", p. 07.

As depicted in Figure 03, the Islamic system engages in three categories of financing modes, among which participatory mechanisms can be relevant for Islamic micro-financing Institutions (IMFIs).

- a) **Non-Profit-and-Loss Sharing Modes:** Non-profit-and-loss sharing modes can include different transaction modes such as:
- **Bay'-mu'ajjal:** is a mode of deferred sale in which the object of the sale is delivered at the time of the contract but the price is paid later. The price can also be paid in future installments.
 - **Murabaha:** is a special type of financial transaction, in which the IMFI buys a good or asset and sells it to the client at a mark-up. The client pays for the good or asset at a future date or in installments.
 - **Ijarah:** is similar to a conventional leasing contract in which the client uses an asset by paying rent.
 - **Ijarah wa iqtina':** is similar to a hire-purchase scheme or a lease purchase scheme in which the installment includes rent as part of the price. When the installments are fully paid, the ownership of the asset is transferred to the client.
- b) **Profit and loss sharing Modes:** Among different profit and loss sharing modes, the following are most commonly practiced:
- **Musharaka:** is an equity participation mode of contract where the financier provides both equity and entrepreneurial skills on a project and thus shares profit or loss on a fixed proportion. The **Musharakah** principle can be used in production (agricultural and non-agricultural). The IMFI can provide part of the financial capital to produce an output and in return receive a share of the profit.
 - **Mudarabah:** Production undertaken under the **Mudarabah** principle implies that the IMFI provides financing and the client manages the project.
 - **Muzara'ah:** is an output-sharing contract specifically for agricultural production where IMFI may provide the funding for the purchase of irrigation equipment, fertilizers, which the landowner uses on his land to cultivate a certain crop.

4.0 AN INTEGRATED MODEL OF ISLAMIC MICRO-FINANCE, ZAKAT AND AWQAF

Diversion of micro-credit for consumption purpose by the borrowers is one of the important sources of credit default in conventional micro-finance. Besides this, charging a generalized interest and at a higher rate has also hindered poverty alleviation through credit rationing and adverse selection problems. These basic challenges of conventional micro-finance can be resolved if an Islamic Micro-Finance Institution is designed in an integrated manner by incorporating the two basic and traditional institution of Islam, the Awqaf and the Zakah with Islamic Micro-finance into a single framework.

Although creating such singular institution may be premature given the present context, in this paper we attempt to outline the basic concept of such a singular

institution. Such an integrated model may effectively resolve fund inadequacy of Islamic MFIs by using funds from the Zakah and the Awqaf. The IMFIs may use the Zakah fund in disbursing funds to fulfill basic consumption needs for the hard-core poor target group in the first place, as on principle no return can be realized from Zakah fund and Zakah fund should be disbursed within one financial year. Zakah fund may also be used in providing the capital investment of or providing the business initiation fund and for that no return should be charged. However, the Awqaf funds may be used as investable fund in providing capital investment and working capital financing for the micro-businesses.

Such an integrated model may reduce the chances of loan default because the basic inherent tendency of the poor to use the loan fund for consumption purpose will be met. As their basic consumption needs are covered, the poor micro-entrepreneurs may be in better position to focus on their business alone. Moreover, the IMFI may initiate financing through different Islamic Shariah compliant modes. Since Islamic financing modes are based on principle of social justice and equity and Riba is prohibited, Islamic MFIs are likely to yield better benefit if they are properly designed. In addition, borrowers will have lower refundable loan, as a result of utilization of Zakah funds, it will result in less financial burden on the poor. Such visible benefits of such a financing organization in contrast to conventional micro-credit organization will be greater.

4.1 Organizational Frameworks and Operational Procedure of our Integrated Model

a) Organization: In modern times, management inefficiency and increased government involvement are two important factors leading to decrease in public participation in Zakat and Awqaf management funds. As a result, Government and donor agencies are increasingly focusing on more private participation or NGO (non-government organizations) participation in different development initiatives. Considering these factors, we propose that an NGO abiding by Islamic ethics and norms with the poverty alleviation objective would be the ideal form of organization.

b) Mission and Vision: The vision of the NGO should be to create a poverty free society based on the Islamic principles of equality, social justice, and balanced growth. The mission of the NGO should be collecting Zakat and Awqaf contributions from a specified locality and providing a credit facility to the poorest segment of society.

c) Objective: The main objective of the NGO should be to reduce poverty through the balanced growth and development of different segments of society. The NGO should focus primarily on developing micro-business among the poor to enable them to attain a sustainable income growth and eventually get out of the poverty trap. In addition to its core service of providing collateral free micro-finance to the hardcore poor, the NGO may also provide financing for other items such as education, health services, and house building.

d) Key Functions: Using an integrated approach, a single concern would be responsible for the management of Zakat, Awqaf and Islamic financing. This organization would perform three key responsibilities:

- Collecting and managing Zakat funds from prospective Zakat donors as well as from other Zakat fund management institutions.
- Collecting and managing Awqaf funds from prospective Awqaf donors, and from other Awqaf fund management institutions.
- Providing micro-credit to the poor on the basis of Islamic Sharia.

In the initial phase, the NGO may concentrate on providing micro-finance and collecting funds from other Zakat and Awqaf management organizations. However, as the organization becomes mature, it may engage in the management of Zakat and Awqaf funds and use them as a stable source of funds.

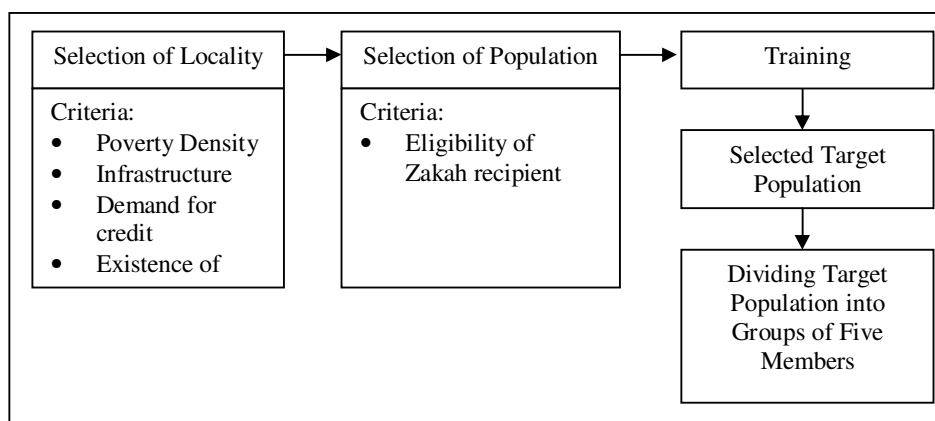
e) Credit Delivery Model: The proposed single model NGO may adapt the success model of Amanah Ikhtiar Malaysia (AIM)³¹, a successful micro-finance institution in Malaysia. The success story of AIM provides empirical evidence that micro-finance facilities may be delivered based on the adaptation of Islamic principles, group recovery, and a credit disbursement model similar to the Grameen Model.

In contrast to AIM, where the Malaysian government actively participates in lending interest free capital and covers operational expenses, the proposed NGO may strive to be self-sufficient terms (meaning no government participation). In its initial stage, the NGO may undertake a few pilot projects to analyze the response of customers in different localities. Selection of such pilot projects may engage following process:

- 1. Selection of Locality:** The NGO would focus on a location with a high poverty density. The selection of a locality would also depend on other factors such as: (1) a demographic study of the locality, (2) identifying probable micro-credit project options, and (3) understanding the prevailing infrastructure, for its important marketing and the distribution impacts.
- 2. Selection of Population:** After selecting a particular area, the NGO would select a target population. It may conduct a household survey, or use references from the existing survey data. Such populations can be selected on the basis of eligibility of Zakat funds or per capita income. In selecting, individual members of the target population, persons eligible to receive Zakat contributions would be chosen first.
- 3. Training:** This target population would be given vocational training in relevant areas. Only after successful completion of the training program, such participants would be eligible for membership.

³¹ Alhabshi, Datuk Dr. Syed Othman, "Poverty Eradication From Islamic Perspectives", p. 01.

Figure 04: Operational Model:



4. The Group: The basic units of the operational model are the groups. The mode of operation within groups would be based on the following principles:

- The groups are made up of five individuals. Among the five persons of a group, the neediest person would be given credit first. After one month, he or she would make first installment payment, the second person would be given credit. After another month a second person would start repayment, the third member would be eligible for credit and so on.
- Repayments of credit would be in weekly installments.
- After they start receiving credit, members of the group would deposit a fixed amount each week as mandatory deposit and insurance for calamities.

f) Organizational structure: The NGO may take its initial initiatives as *pilot projects*. Such *pilot projects* can be described as “units”. A unit manager will lead the overall functioning of a particular locality and manage a number of credit officers who will disburse and collect the micro-credit loans to and from the borrowers. Credit officers will be responsible for the overall credit appraisals, credit delivery, monitoring, and recovery process. One credit officer will be in charge of a number of group operations. In addition to regular credit officers, a team of two or three credit officers will be in charge of credit monitoring to determine whether or not credits are used properly. Such a team will also provide additional information, which will be used by unit managers and general management to analyze the model performance.

4.2 Financial Management Framework

4.2.1 Fund Management Principles: In the proposed model, the NGO will use Zakat and Awqaf funds as the two major sources of financing. On principle, Zakat funds do not need any return or repayment. Zakat funds would be used for two purposes: to fulfill basic needs and to provide capital investment so that a member could start a micro-business.

Awqaf funds could be used as source of funding as well. From Awqaf funds, both capital investment and working capital investments could be made. In case of capital

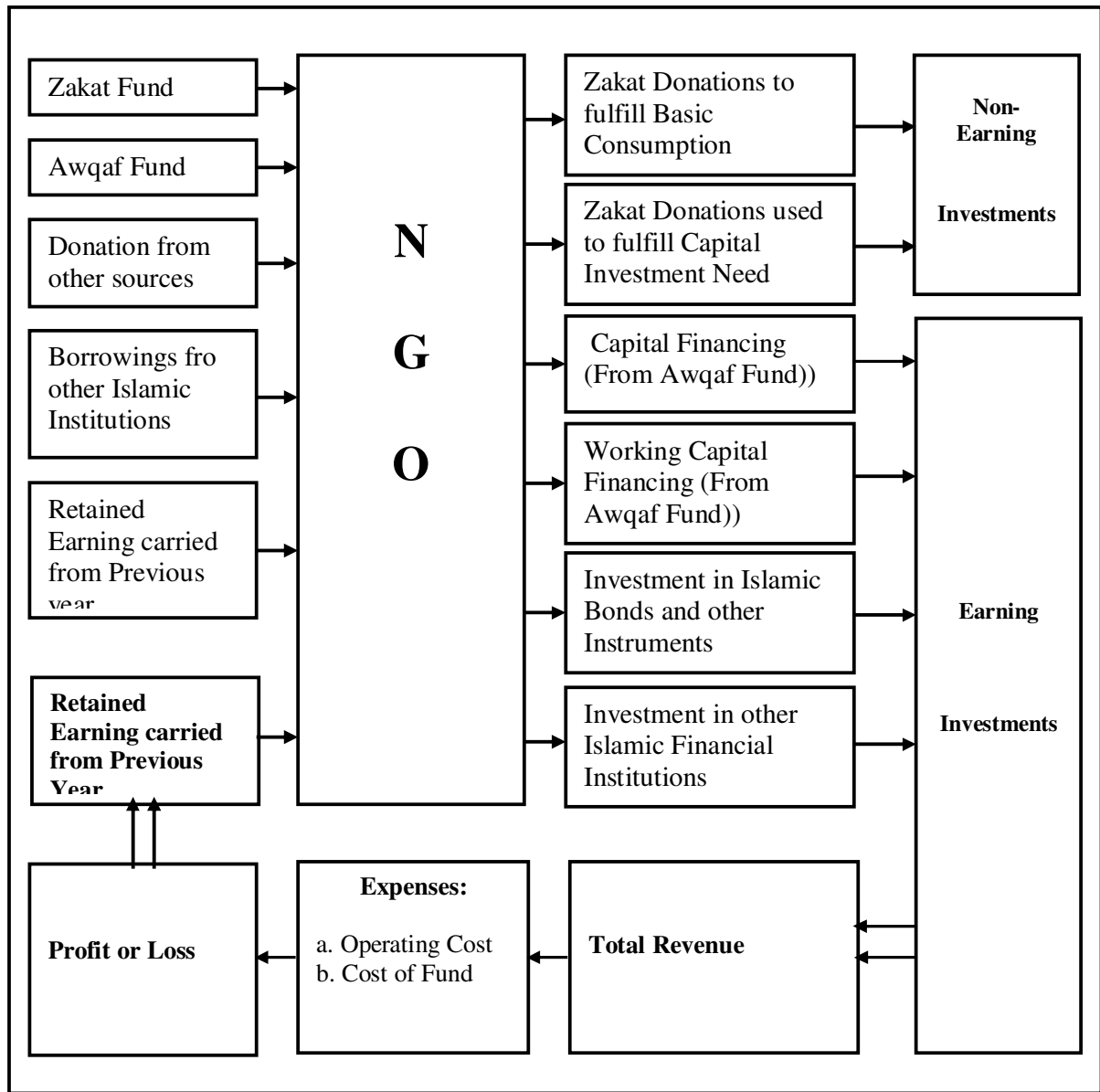
investment with Awqaf funds, the NGO would engage Mudaraba mode. However, in the initial phases, the NGO may engage Awqaf funding only for working capital investment. For operational simplicity, the NGO would prefer the Murabaha mode of financing for working capital as that will also ensure that short-term credit is utilized in a proper way. Moreover, as the fee is fixed, it will ensure the NGO with stable and predictable revenue during the initial years. As Zakat fund's investment in capital investment will not generate any revenue, the NGO will be better off investing in Murabaha mode for working capital financing.

In addition to these two major sources, the NGO would also collect funds from borrowings from Islamic banks and financial institutions, deposits from members, deposits from its employees, and deposit schemes for non-members. If needed, the NGO can also go to the capital market and raise funds through issues of share capital. In its overall financial operations, the NGO will comply with Islamic banking principles and Islamic Sharia'h benchmarks. The diagram on the next page illustrates a graphic presentation of the financial model of the NGO.

4.2.2 Sources of Funds: As previously mentioned the NGO will raise funds from different sources with different contractual modes. In principle, the NGO will not engage in raising funds that does not conform to the Islamic norms of banking. The NGO will collect funds from the following sources.

- Zakat contributions will be collected from prospective members, Zakat donors, or other Zakat fund management organizations. In the initial phase, the NGO might focus on its core function of micro-finance instead of collecting and managing Zakat funds. In countries where the government, by law, does not enforce Zakat, collecting sizeable amounts of Zakat at the initial stage might be a challenge. However, considering the way Zakat funds are collected, for any investment made on Zakat funds, no repayment or return can be charged.
- In the initial phase, the NGO might opt for a similar strategy in collecting Awqaf contributions. However, on investments made from Awqaf contributions, return and repayment can be charged on *Mudaraba* mode. All of them should, however, be used for benevolent purposes.
- Donations from other institutional and non-institutional sources might require repayment of principle, and in some cases profits, in addition on *Mudaraba* mode.
- Borrowings from Islamic Banks and non-banking financial institutes will be collected based on Sharia'h principles, especially through *Mudaraba* mode.
- The NGO can also generate funds from equity shares or from capital market participation.

Figure 05: Fund Management Model



4.2.3 Uses of Funds: The basic activity of the NGO is to provide credit for micro-businesses. As micro-business requires credit for both capital investment and the fulfillment of working capital needs, the NGO can arrange for both in a balanced way. Its capital investments can create the base upon which to provide working capital credit or short-term credit. As mentioned earlier, the NGO would involve Zakat contributions for non-redeemable capital investment with no return only. However, the working capital credit will be delivered based on the Murabaha model.

Apart from these two basic investments, the NGO will also engage in *Mudaraba* investment modes after it can build its own capacity and its clients are well versed in accounting principles. Moreover, investment in micro-credit, the NGO will undertake

diversified investment activities such as investing in Islamic bonds. Earnings from such non-operational activities will provide a cushion during profit fluctuations resulting from uncertainties.

5. SUMMARY

Micro-finance involves providing credit without collateral to the marginally poor. The traditional micro-finance suffers from high default risk, high operational costs, and low returns. Successful NGOs like Grameen Bank, ASA and BRAC have shown that even though there are such risks, micro-finance can also be used to create and sustain successful businesses.

Weaknesses of conventional micro-finance such as charging high fixed interest rates, credit diversion, credit rationing and non-conformity with the Islamic faith of the majority population necessitates the creation of an Islamic microfinance. There is an opportunity for Islamic micro-finance to grow by catering to the needs of the under-privileged Muslim population.

In our proposed model, we combine Islamic micro-finance with two traditional Islamic tools of poverty alleviation such as Zakat and Awqaf in an institutional set-up. The inherent nature of the proposed model may ensure equitable distribution and welfare among the poor. As the model is based on profit sharing and concessional contract modes, distribution of earnings should be allocated among different stakeholders such as depositors, shareholders, investors in the NGO. The proposed model will be financially viable and sustainable in the long run, resulting from lower default rates reduced the proper use of Zakah funds, which do not require any return. This will create a win-win situation for all stakeholders.

If implemented, this model will contribute to poverty alleviation by combining all three approaches: positive measures (like increasing income growth through development of micro-business for the poor), preventive measures (through ensuring functional re-distribution among factors of productions) and corrective measures (engaging Zakat and Awqaf).

Unlike conventional MFIs, under the proposed model, the poor borrowers will have less debt burden as their capital investments will be partly met by funds from zakah that does not require any repayment. As Islamic financing modes are based on profit-and-loss sharing principle, so there will not be any fixed interest payment burden for the borrowers. All these factors will lead to lower default rates and graduation from poverty will be higher.

To sum up, the proposed Islamic micro-financing model will yield more benefit towards the overall social welfare. If such an IMFI is undertaken on a pilot project basis, and further operational adjustments are made accordingly, there may be a visible impact on poverty reduction among the targeted poor population. Finally, if a number of NGOs apply this model, the aggregate benefit will be greater.

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